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REGIONAL DISPARITIES AND TRADE AND INVESTMENT LIBERALISATION IN CHINA

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Introduction

1. Sharp territorial disparities in China are a long-standing phenomenon that date back to the 19th century. The dichotomy of a coastal China, geared towards exports, and an inland China, a supplier of labour and raw materials, was to a large extent the result of the "open ports" policy. Forced upon the Qing dynasty by the European powers, it was the consequence of the Opium War and of unequal treaties.

2. The egalitarian, redistributionist policies of the Maoist period did not reduce those disparities. The dichotomy between coastal China and inland China lessened, but at the same time there emerged rising disparities within provinces and a widening imbalance between urban China and rural China.

3. The purpose of this chapter is to assess the extent to which the widening of regional disparities that has been observed in China since 1990 is likely to be further increased by growing outreach and membership of the World Trade Organization (WTO). While this outreach offers opportunities, for some regions it could also increase economic and spatial polarisation.

4. Indeed, while China's accession to the WTO should on the whole have a positive effect on the level of growth, it may have considerable individual, sectoral, but also territorial, redistributive effects. In particular, there could be a widening of the territorial divide between coastal areas and the interior, and between town and country, and the creation of new rifts between north and south and within major metropolitan areas. The need for political and social stability demands that these disparities be limited, which entails the adoption of a balanced and sustainable development strategy.

5. That strategy must include actions to break the isolation of certain territories (by installing transport and communications infrastructure), to allow greater mobility of persons, goods and capital, and thus to develop an internal market, ensure macroeconomic stability, establish an institutional framework that can reconcile transition and development, and to provide territories with sufficient resources to meet the responsibilities that have been devolved to them.

6. This chapter is divided into four parts. The first reviews the nature and extent of territorial disparities in China. The second analyses the policies that the Chinese authorities have implemented to reduce them over the past twenty years, drawing on the experience of certain OECD countries. The

third assesses the potential impact of trade and investment liberalisation (TIL) on those disparities. The fourth proposes a set of recommendations for making this liberalisation an opportunity for territorial development in China.

Long-standing and sharp disparities

7. Disparities in territorial development have existed in China for a long time. The divide between the coasts and the interior dates back to the opening-up policy of the 19th century and the establishment of international concessions following the Boxer Rebellion (1900). The urban/rural divide was the consequence of the industrial policies to foster urban development implemented during the Maoist period (1949-1978). Today these disparities are highly disturbing: the absolute differential (as measured by per capita GNP) between the poorest province (Guizhou) and the richest one (Shanghai) is 14 to 1 (Démurger, 2000). Following the launch of reforms in 1978, the differential between provincial per capita incomes narrowed initially, and then began to widen once again in the 1990s.

Disparities heavily dependent on the unit chosen to measure them

8. The inequalities of development in China vary, depending on which geographic scale and which indicator are chosen to measure them.

China's geo-economic divides

9. Disparities between town and country are the main source of disparities in China (Lin *et al*., 1999)[1]. It is true that the urban/rural dichotomy and the divide between coastal and inland provinces often overlap, since the western and central regions are essentially rural. Disparities between provinces are secondary to these other disparities, even if they are tending to increase. Last come disparities between districts within a given province.

10. The urban/rural contrast explains more than 50 per cent of the territorial inequalities in China over the entire reform period (Lin *et al*., 1999). This contrast, which is already a sharp one when measured by macroeconomic indicators, becomes even sharper if social indicators are used. The differential ranges from 2.5 to 11 for all macroeconomic indicators-GDP, income, consumption, per capita savings [see Table III.D.2(1)].

Table III.D.2(1). **The urban/rural development gap**

11. The use of social indicators amplifies this urban/rural divide. With an indicator of income in the broad sense -- *i.e.*, encompassing social transfers (health care and education benefits, unemployment benefits, housing subsidies and old-age pensions) -- the gap between town and country is 4 to 1. In rural areas, 17.6 per cent of the population is poor, versus only 0.4 per cent in urban areas (Gustafsson & Li, 1998). A rural resident spends 62.40 renmimbi per year on personal health care versus 179.68 for

1. The authors use a decomposable Theil index which makes it possible to assess the relative contributions of the various geographic divides to the overall level of territorial inequalities.

urban residents. Seventy-four per cent of urban households are equipped with plumbing facilities, versus only 7 per cent of rural households. Lastly, for refrigerators, the figures are 60 per cent of urban households and only 4 per cent of those in rural areas. Where health services are concerned, however, the gap is much less deep as a result of policies set in place during the Maoist period.

Figure III.D.2(1). **The urban/rural gap in living standards: consumer goods[1]**

12. Disparities between provinces account for nearly 40 per cent of the overall development gap. They reveal not only the contrast between coastal China and inland China, but also, more subtly, China's division into economic macro-regions.

13. In the five most successful coastal provinces, per capita income growth between 1980 and 1996 averaged between 6.4 and 9.2 per cent per annum in rural areas and between 5.5 and 7.9 per cent in urban areas. The corresponding figures for 11 non-coastal provinces[2] were 3.9 to 7.3 per cent in rural areas and 3.6 to 6.5 per cent in urban areas (Gang, Perkins & Sabin, 1997). Per capita income in the wealthiest provinces, in purchasing power parities, is now double to triple that of the poorest provinces.

14. China can be divided into four economic macro-regions (Naughton, 1999; Giroir, 1999 and Gipouloux, 1998). The city-provinces (Beijing, Shanghai and Tianjin) are prosperous and outward-reaching commercial, industrial and administrative centres which have 85 per cent of their work force employed in secondary and tertiary industries, and their per capita GDP is nearly double that of the coastal provinces. The presence there of the most prosperous State-owned enterprises provides subcontracting opportunities for the rural firms that are springing up on the periphery.

15. The three north-eastern provinces (Heilongjiang, Jilin and Liaoning) have made up the industrial heart of China since the Japanese occupation. It is an area undergoing major restructuring in response to challenges similar to those of the transitional economies of Central and Eastern Europe. The structure of production is that of the Soviet model, dominated by heavy industry and arms factories. Discriminatory measures against private businesses persist. Transport infrastructure, dating back to the Japanese occupation period, is colonial-style, geared towards the extraction and export of raw materials and dominated by the Harbin-Dalian railway.

16. The seven coastal provinces (Shandong, Fujian, Guangdong, Zhejiang, Jiangsu, Hainan and Bebei) enjoy income above the national average and owe their recent vitality to the policy of reform and openness in effect since 1978. Their success is attributable to the remarkable growth of rural enterprises since the early 1980s (Box 1) and the crucial role of foreign direct investment-driven by Japan, South Korea and, especially, overseas Chinese, including many from Hong Kong and Taiwan.

17. Lastly, the six central agricultural provinces (Anhui, Hubei, Hunan, Henan, Jiangxi and Shanxi) and the twelve western provinces (Shaanxi, Inner Mongolia, Xinjiang, Tibet, Qinghai, Ningxia, Gansu, Sichuan, Yunnan, Guizhou, Chongqing and Guangxi) have per capita income and GDP levels that are below the national averages. Ownership is largely in State hands, and the secondary and tertiary sectors employ between 30 and 40 per cent of the labour force in those areas. These regions do, however, enjoy a major tourism potential, which has yet to be adequately exploited. The western provinces, which *inter alia* were traversed by the famous silk route, boast a wealth of architectural and cultural treasures.

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2. Liaoning, Jilin, Heilongjiang, Anhui, Henan, Hubei, Hunan, Sichuan, Shaanxi, Gansu and Ningxia.

18. Intra-provincial disparities between townships or districts rank third, accounting for only 10 per cent of overall territorial disparities. They are far from negligible, however, in view of the disparities in mortality rates (Tsui, 1998)[3]. The territorial and development disparities within the provinces of Guangdong, Yunnan, Gansu and Sichuan are greater than those of China as a whole. Moreover, within the large metropolitan areas there is a trend towards socio-spatial segregation between prosperous central and near outlying areas, on the one hand, and "hamlets" peopled by immigrant workers clustered by provincial origin (*e.g.*, the Xinjiang and Henan hamlets of Beijing) (He, 2000) and located further out from the centre, on the other.

Diversity that is more economic than social

19. The territorial divide between the coast and the interior differs, however, depending on the indicator used to measure it (Pairault, 1999). Macroeconomic indicators accentuate geo-economic divides. Regional per capita GDP differentials expressed in PPP show gaps of 1 to 9 (UNDP, 1999). Shanghai has a per capital GDP level, expressed in PPP, equivalent to that of South Korea or Argentina. Fujian has a GDP equivalent to that of South Africa or Thailand. Lastly, Tibet's GDP is equivalent to that of Cameroon, and Gansu's to that of Mozambique.

20. The best infrastructure, a majority of township and village enterprises, and the bulk of foreign direct investment are concentrated in the most dynamic coastal provinces: over 85 per cent of China's foreign direct investment and foreign trade is concentrated in the coastal provinces. In contrast, more than half of the poorest 80 million Chinese live in western provinces (Sichuan, Gansu, Guizhou, Yunnan, Qinghai, Shaanxi, Ningxia, Tibet and Xinjiang). This part of the country attracts less than 5 per cent of aggregate foreign investment in China [see Table III.D.2(2)].

21. The ranking remains the same if it is based on the Human Development Index (HDI) [see Table III.D.2(3)], although there are some differentials—negative for Shanxi, Inner Mongolia, Liaoning, Hunan, Sichuan, Shaanxi and Guizhou; and positive for Fujian, Jiangxi, Qinghai and Ningxia. These differentials would suggest a lesser degree of social diversity.

22. The apparently lesser social uniformity in fact conceals sharp disparities, which emerge fairly clearly when more specific indicators are used. For training and literacy levels, the correlation with the growth rate is slight, the correlation coefficient being relatively low (R = 0.38 in 1997) (Payrault, 1999). For the sake of strategic priorities and the imperative of industrialisation, northern and western provinces were favoured under Maoist education policies. In contrast, the south-eastern provinces, which today are the most dynamic, were long left behind, and their performance in terms of literacy rates is very mediocre [see Table III.D.2(3)].

23. In contrast, with regard to life expectancy and school enrolment rates, the results are as concentrated as those for GDP. For both of these indicators, there is a strong correlation with per capita GDP (R = 0.78 for life expectancy and R = 0.70 for the school enrolment rate). The provinces of Gansu, Yunnan, Qinghai, Guizhou and Ningxia, which are all remote inland provinces, have the greatest deficit in education.

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3. However, this finding was arrived at from 1982 data.

Table III.D.2(2). **Disparities between provinces: economic indicators**

Table III.D.2(3). **Disparities between provinces: social indicators and digital divide**

A convergence process active in the 1980s, interrupted in the 1990s

24. The launching of reforms in 1978 led over the ensuing decade to a gradual reduction in the dispersion of per capita income. But in the first half of the 1990s, the overall level of disparities began to rise anew, in particular because of the aggravation of the territorial divide between coastal provinces and those in the interior.

The relative convergence of the 1980s

25. Whichever indicators of inequality are used (Gini index, Theil index, coefficient of variation or log variance), the trend in the dispersion of per capita GDP between Chinese provinces testifies to the existence of a certain degree of convergence during the 1980s (See in particular, Lin *et al.*, 1999; Démurger, 2000 and Zhang, 2001).[4]

Figure III.D.2(2). **Dispersion trends measured by the log variance of per capita GDP**

26. Thus, Figure III.D.2(2) shows a tendency towards a reduction in the dispersion of per capita GDP for China as a whole until 1990, which can be explained by a variety of phenomena: a greater role played by market mechanisms, an easing of a redistributive pricing system slanted towards urban development, the remarkable vitality of rural enterprises, which raised the growth rate in rural provinces and, at least until the mid-1980s, a reduction in the urban/rural divide .

27. As shown by Figure III.D.2(2), the reduction of inequalities within the large regional areas (intra-area variance) was even greater than for China as a whole. Nevertheless, disparities between areas (inter-area variance) tended to rise until the end of the 1980s. This stems from the fact that while the three municipalities (Beijing, Tianjin and Shanghai) had relatively low growth rates over the decade, the southern coastal provinces, which had started out with an income level lower than the national average, experienced very rapid growth. Positive discrimination policies on their behalf resulted in an unprecedented shake-up of the regional economic hierarchy (Naughton, 1999). The remarkable take-off of provinces such as Guangdong and Fujian illustrates this shake-up.

4. Trends in the dispersion of per capita income in the Chinese provinces are well documented in recent literature.

The trend since the 1990s

28. As Figure III.D.2(2) shows, at the beginning of the 1990s, while convergence continued to improve within the four large areas, a reversal of the trend took place, both for China as a whole and between the regions. This stemmed from the growing difficulties of township and village enterprises and from a policy to promote urban development.

29. This relatively generous policy of urban income subsidies was financed by a double tapping of rural incomes: an increase in local taxes on farm households, plus an inflationary rise in the tax on rural income because of an accommodating monetary policy. Indeed, prices rose more sharply for goods that were non-exchangeable, because of low productivity, *i.e.*, in rural provinces.

30. This triggered a loss of purchasing power in certain provinces. But some of them, using their more extensive policy-making authority, responded by taking protectionist measures. These customs barriers, whether tariff-based or not, impeded inter-regional trade and thereby reduced the least advanced regions' chances for development, and limited their attractiveness for foreign direct investment, which is one of the main factors shaping territorial disparities in China. The correlation between regional growth and FDI is very strong. Institutional factors (*e.g.*, guarantees of individual and family property rights), transport infrastructure and human capital in the broad sense (encompassing public health and education), which play a considerable role in regional growth (Démurger, 2001), are also important in attracting FDI (World Bank, 1997 and Oman, 1999).

Box III.D.2(1). **Township and village enterprises: the powerhouse of the Chinese economy?**

Rural industrialisation expanded remarkably in China in the 1980s, much like the proto-industrialisation of rural Europe in the 19th century. In China, township and village enterprises (TVEs) have inherited the rural industries set up prior to the reforms by provincial CPC officials. The TVEs' aggregate turnover increased sixfold in real terms between 1985 and 1998. They now account for over a third of China's GDP and created 107 million new jobs between 1978 and 1996 (Park, 2000 and O'Connor, 2000).

The power to create and -- since the early 1990s -- privatise these enterprises via share distributions to employees lies with local township and village authorities. From a legal standpoint, TVEs are virtually identical to co-operatives. Local authorities manage the enterprises, under the supervision of their employee-shareholders. They can also privatise them: in the extremely dynamic coastal provinces of Jiangsu and Zhejiang, the proportion of TVEs under collective ownership fell from 78 per cent in 1994 to less than 20 per cent in 1999 (Park, 2000).

The success of these TVEs is attributable primarily to a favourable local environment. Because they are not closely tied to more powerful political and administrative entities (such as provinces, districts or the Party), it has been possible to make them comply with tight budgetary constraints. In addition, a relative easing of the system of administered farm prices enabled a substantial rise in rural savings rates, thereby providing these enterprises with new financing opportunities.

TVEs are currently facing increasing problems: a slowdown in the pace of Chinese growth in the wake of the Asian crisis; a tightening of monetary policy; the inefficiency of local capital markets, which are slanted in favour of a public sector that happens to be insolvent; and a rationing of credit by banks whose portfolios are weakened by bad debts. If TVEs are to resume their role as a catalyst, it will entail further restructuring of the local public sector and, above all, a reform of their legal status. The Chinese authorities now appear to be contemplating the possibility of creating a "limited company" status for them.

Policy strategies having limited impact on territorial development

31. Two major strategies have been deployed by the Chinese authorities over the past fifty years: the central planning of the Maoist period, and the "creative market decentralisation" of the reform period. The overriding objective of both strategies was not to enable lagging provinces to catch up with leading ones, but to enable China as a whole to catch up with the West. The Chinese authorities have gradually become aware of the need for balanced regional development, if only out of fear of centrifugal tendencies and the expression of a certain irredentism by national minorities, and have therefore recently chosen a new course.

Strategies of the past: central planning and creative market decentralisation

Central planning: 1950-80

32. In neither of the forms it took -- the industrialisation-oriented deconcentration of the "Great Leap Forward" or the redistributive centralisation of the "Third Front" -- did central planning have much impact on territorial disparities.

33. The strategy of the Great Leap Forward (1958-60) was to encourage the accumulation of capital and urban development. It entailed tapping peasant income through a redistributive system of farm and industrial pricing and administrative limitations on the mobility of rural workers.

34. The outcome of the concentration of capital in urban areas, and of the *Hukou* system, was to reduce the stock of available capital per rural worker and to create a redundancy of farm labour. These two effects led to a reduction in apparent labour productivity in rural areas and widened the divide between town and country (Cook, 1999).

Box III.D.2(2). **The *Hukou* system**

The Chinese system of restrictions on the migration of rural labour to the cities (*Hukou*) was instituted in the wake of the great famine that raged between 1959 and 1961 (Carter, 2000). It is still in effect. *Hukou* is a system for registering households that would like to move to a town.

Registration must be purchased, because it confers access to housing, children's education, medical services and certain food subsidies. Because the fees are exorbitantly expensive, they constitute a barrier to the mobility of the rural population. Another obstacle is the lack of a market for land: the 70 million migrants who leave the land each year abandon their implicit right to farm their parcels and thus abandon the projected flows of future farm income.

The system was eased in the 1990s, and food subsidies for urban residents were reduced. In addition, local authorities have sought to facilitate rural migration to the cities in order to reduce excess rural labour. In particular, farmers are now entitled to sublet their parcels contractually if they choose to migrate. On the other hand, they do not have the right to sell them, nor can they transfer them. Nevertheless, the *Hukou* system is still in place and constitutes the main obstacle to rural-to-urban labour mobility in China (Mallee and Zhou).

35. The "Third Front" strategy, implemented in the mid-1960s, was inspired by Chairman Mao's famous speech "On the Ten Major Relationships", which affirmed the need to bridge the development gap between coastal provinces and those in the interior. It was a policy rooted in both the regime's egalitarian ideology and in strategic considerations arising from the latent conflict with the Soviet Union. It was implemented thanks to the centralisation of investment decisions, which made it possible to redistribute productive resources amongst the provinces. But the policy's impact on territorial disparities was limited (Naughton, 1999).

Creative market decentralisation: 1980-90

36. Maoist China was highly centralised. The Party's instructions were to be applied to all provinces with no distinctions whatsoever. Select production units, factories or people's communes, such as the famous Dazhai brigade in Shaanxi, were held up as examples for all of China.

37. With the 1982 Constitution, a new era began, since the Constitution devolved substantial powers to the provinces, which became the driving force in China's economic and political transition (Montinolla, Qian & Weingast, 1995). The provinces became free to set price levels, within the framework of a system of local public markets; the regional minimum wage; and regional investment and customs tariffs, as part of their new trade-related powers. Provinces were given the authority to approve FDI without the central government's prior consent. In the early 1990s, they embarked upon a vast programme of restructuring and privatisation of the local public sector. Competition law is also being formulated at the regional level.

38. Local governance was unquestionably improved as well. The Party's central apparatus was scaled back, and while appointments of local leaders still require the centre's prior consent, those leaders act ever more independently of Beijing (Li & Lian, 1999). The first direct election of municipal authorities took place in 1998. At that time, the Carter Foundation of Atlanta contributed to the installation of pilot computer systems to tally votes in the villages in which elections were held.

39. While the role of guilds and other interest groups (such as the famous "Nanking Transporters' Guild" between the two world wars) was a characteristic of coastal provinces only, the spectacular expansion of the local press and of village associations testifies to the growing role played by civil society in rural and inland provinces. Despite the resurgence of traditional peasant tax rebellions, judicial settlement of disputes between elite groups and local populations was instituted, with a particularly steep rise in tax disputes (Bianco, 2000).

40. Decentralisation also involved a strategy of positive discrimination in favour of the southern coastal provinces. *Inter alia*, this was the goal of the so-called "opening-up" policy deployed in the 1980s with the creation of "Special Economic Zones". While this was accompanied by an unquestionable propagation effect within the coastal provinces (Démurger, 2000), the dominant outcome of this policy of positive discrimination was nonetheless to widen the territorial divide between the coasts and the interior.

Box III.D.2(3). **Special Economic Zones and Economic Development Zones**

These economic zones can be defined as geographic areas within a given territory in which selected economic activities are fostered through preferential tax policies and regulations. While creation of special economic zones (SEZs) is a prerogative of the central government, development zones are set up by the provinces.

In the 1980s, five special economic zones -- Shenzhen, Zhuhai and Shantou in Guangdong province, Xiamen in Fujian province, and then Hainan Island -- were created at the initiative of the State Council. These areas were chosen *inter alia* because of their coastal locations and, especially, their proximity to Hong Kong, Macao and Taiwan.

These zones, enjoying preferential tax treatment and provided in the 1980s and 1990s with quality infrastructure, were to serve as laboratories for China's reforms. They were also to be the starting point for an inward drive to the inland provinces, thanks to FDI-related technology transfers. FDI flows in these zones increased 30-fold between 1980 and 1995. As is the case for similar areas set up in the OECD countries, their attractiveness to FDI is attributable less to the start-up benefits they offer than to their geographic location, the quality of their labour force and infrastructure and their relative judicial security. Taking advantage of rising costs in Hong Kong and Taiwan, these SEZs were able to set up local capital markets, including venture capital markets. Stock exchanges were set up in Shenzhen and Shanghai (Pudong). The Dalian economic development zone, which was set up by Liaoning province in the 1990s, has new business incubators that have spawned start-ups in the forefront of technological progress.

The economic performance of these zones is remarkable. The vitality of foreign trade and FDI-related technology transfers have generated a considerable rise in productivity, inducing a growth rate far in excess of the (already very high) national average. Shenzhen, for example, experienced real growth of 35.5 per cent per annum between 1985 and 1995, while the growth rate for China as a whole was 10 per cent. The extent to which this growth is propagated to neighbouring provinces (through technology transfers and learning by doing), although perceptible, remains limited (Ge, 1999).

41. There was also extensive decentralisation of budgeting. An unofficial procedure for sharing tax revenues between the central and provincial authorities was instituted in the latter half of the 1980s. As a result, 70 per cent of general government spending and tax revenues are controlled by local authorities.

42. These figures understate the actual latitude available to local authorities, since they do not include off-budget revenue which in 1998 accounted for 50 per cent of the total: Figure III.D.2(3) shows the considerable proportion of off-budget spending on the local level as compared to that of the central government. This off-budget financing consists primarily of ad hoc taxes, which are levied and collected at the local authorities' sole political discretion (the *Tanpai* system). With regard to regional disparities, the inescapable conclusion is that all of the measures instituted since 1982 have likely increased growth differentials between provinces and, in particular, between coastal provinces and those in the interior.

43. The fact that until 1994 the local authorities had a monopoly on the collection of local and national tax revenue further clouded this lack of transparency and made local public finance in China even more arbitrary than it already was.

Figure III.D.2(3). **Proportion of off-budget revenue and spending: central vs. local government**

The current route: seeking balanced development

44. Reducing disparities between coastal and inland provinces is now a core priority of the Chinese authorities. They are determined to put a halt to the widening territorial divide by helping the inland provinces to better exploit their comparative advantages, and especially the abundance of raw materials. This objective is set forth clearly in the introductions to the 8th, 9th and 10th five-year plans.

45. More recently, a general programme for developing the West was formulated in connection with the 10th five-year plan [Box III.D.2(4)]. To achieve this objective, the authorities have two types of instruments at their disposal: infrastructure policy and tax policy.

Box III.D.2(4). **The Western Development Strategy**

Launched by the Chinese government in 1999, the Western Development Strategy was officialised in March 2000 by the creation of a specific agency to oversee its implementation (*Office of the Leading Group for Western Region Development*). This office comes directly under the State Council and is directed by the chairman of the State Planning and Development Commission. The aim of this strategy is to narrow the disparities in income and development between the coastal provinces and the western provinces by creating an environment conducive to the development of the twelve western provinces.

The aims of the strategy are to:

- Promote infrastructure development, chiefly by central government funding;
- Attract investment by putting in place preferential policies, in particular preferential tax regimes;
- Promote environmental protection, especially in areas subject to erosion;
- Foster an environment conducive to the development of science and technology-related activities, and to attracting skilled labour;
- Encourage the involvement of the coastal provinces in their neighbours' development.

Some measures have already been announced and implemented since 1 January 2001 for a 10-year period. They include *inter alia* additional public expenditure, increased support and lower tax rates. Nearly 100 billion yuan per year are due to be spent by the central government in the Western Region, financed by bond issues, bank loans and other investment. Corporate profit tax will be cut from 33 per cent to 15 per cent for local and foreign enterprises. Private enterprises will be given more freedom, which should put them on an equal footing with State enterprises. Lastly, various incentives are scheduled to be introduced to attract investment in capital-intensive industries such as energy, transport and telecommunications.

Infrastructure policy

46. The Chinese government has embarked upon a vast infrastructure programme to bring the inland provinces out of their isolation. During the 1990s, spending on infrastructure as a proportion of GDP rose from 1.26 per cent to 4.5 per cent. Under the 10th five-year plan, CNY 800 billion is to be expended to finance infrastructure and attract foreign investors. This policy of heavy and light infrastructure was introduced at two levels—that of the central State and that of the provinces.

47. Beijing has managed to give priority to major infrastructure without neglecting the development of minor infrastructure. Projects recently approved by the State Planning Board for the 10th five-year plan include the construction of 150 000 km of new motorways in the western provinces and the laying of 955 km of railroad track linking Xian (Shaanxi) and Hefei (Anhui).[5] Other infrastructure projects include telecommunications networks and dams in western China. To be able to deliver on this promise, Beijing would like to float a US$12 billion bond issue to finance natural gas pipelines and electric power plants (official figure from the State Planning Board). A 4 200 km gas pipeline is also being built between the Tarim basin in Xinjiang and Shanghai. Lastly, Beijing is trying to foster co-operation between TVEs in the interior and those in coastal provinces, and to set up "technological project zones" to spur dissemination of innovations from the most dynamic coastal provinces to interior provinces.

48. For their part, the central and western provinces have put the emphasis on transport and communications infrastructure so they can exploit their abundant natural resources: non-ferrous metals in Gansu; potash mines in Quinghai; oil in Xinjiang; coal and natural gas in Shanxi, Shaanxi and Inner Mongolia; hydro-electric resources in Sichuan and Guizhou; and phosphorus in Yunnan, Guizhou and Hubei.

49. The combination of these policies renewed the momentum for development in certain western and central regions, while rising factor costs in the coastal provinces tended to drive investments towards the inland provinces, prompting new industries, including some Western firms, to establish a presence in Western China [Box III.D.2(5)].

5. The cost of these projects is estimated at US$2.8 billion.

Box III.D.2(5). **Western enterprises in Sichuan province**

More and more Western enterprises are setting their sights on China's western provinces. One such company is Lafarge, which has entered into a joint venture with Dujiangyan Building Materials Corporation -- an enterprise with ties to the municipality of Chengdu in Sichuan province -- to build an ultramodern, world-class cement factory. Lafarge is putting up 75 per cent of the capital, and its Chinese partner 25 per cent, essentially in kind (the quarry, the land and rights to operate the mine for fifty years). The total investment amounts to US$150 million, 65 per cent of which will be financed by Lafarge and its Chinese partner, with the International Finance Corporation (IFC) providing the balance. The licence was obtained very quickly, following a call for tenders. The cement works, which will be run by Lafarge, is the largest foreign investment in Sichuan province.

Another large project is the Vivendi group's construction of a drinking water factory in Chengdu. The plant is located 27 km from Chengdu, and the Vivendi-Marubeni tandem will construct a pipeline to carry the water to the city. Vivendi, which will manage the facility for 18 years, has been able to borrow money from multilateral banks -- the Asian Development Bank and the European Investment Bank -- which have agreed to cover the political risks involving the municipal government.

A representative office of Banque Nationale de Paris (BNP) is also present in Chengdu, as is SNECMA, which has set up a joint venture with the airline company China Southwest to take over a workshop that formerly repaired Russian aircraft engines. Another SNECMA joint venture is a flying college for mechanics employed by Chinese airlines, in which eight hundred students have already been trained.

Their experiences have shown that the quest for multiple partnerships between Chinese and foreign enterprises, and between private interests and government, has spawned major technology transfers. Chengdu has been one of the leading destinations for foreign enterprises in China's interior provinces. The technology transfers have enabled the city to exhibit a relative degree of innovative vitality.

Tax measures

50. The central authorities have made massive use of tax measures. The privileges heretofore accorded to SEZs have now been extended to large interior metropolitan areas like Chongqing and Wuhan. As a rule, such tax measures, which also generate major distortions, can hardly offset the comparative disadvantage of geographic isolation.

51. The fiscal reform of 1994, and the one begun in 1999, attempted to make up for the problems generated by decentralisation by increasing the budgetary preponderance of the State. Local budgets' share of aggregate general government budgets fell from 70 per cent to 50 per cent in the latter half of the 1990s (Zhang, 1999).

52. Western-style local taxation was introduced, including a new formula for sharing tax revenue between the State and the provinces, with the State collecting shared taxes such as VAT and income tax.

53. A new system of horizontal equalisation was also set up in 1995, based on budget transfers from provinces having per capita GDP at least 25 per cent above the national average to those where it is at least 25 per cent below.

54. This equalisation is quite limited, however, at scarcely 0.5 per cent of the central government budget, which itself is very low (7% of GDP). For its part, South Korea manages to harness an equalisation capacity equal to 16 per cent of the central government budget (Zhang, 1999). Moreover, the trend is heading even lower.

55. Despite these provisions, the resources of the poorest provinces have remained quite limited, prompting greater use of off-budget revenue (*Tanpai*), despite the 1994 tax reform which sought to moderate the practice of *Tanpai*. The trends depicted in Figure III.D.2(3) show that this measure in no way prevented the growth of the off-budget portion of local expenditure, while over the same period the off-budget portion of central government spending was reduced. The tax reforms therefore seem inadequate to offset decentralisation, which would appear to penalise rural provinces. This certainly explains why in March 2001 Chinese Prime Minister Zhu Rongji announced a reform plan to unify the system of taxation for farmers with a flat 7 per cent tax on all their income. This will entail a reorganisation of local governments and the institution of subsidies from Beijing.

WTO accession: the consequences for regional development in China

56. To explore the likely consequences of China's upcoming accession to the WTO, we shall take two approaches. The first is to examine input from the various research and analysis that has been conducted to date; the second is to classify China's 31 provinces into six major categories, on the basis of economic specialisation, in order to get a clearer idea of the consequences of liberalisation on each one.

A review of the literature by industry

57. In the past few years, the prospect of China's forthcoming accession to the WTO has spawned a number of studies of its likely impact, and especially since the signature of the bilateral agreement with the United States in November 1999. Most of the studies are based on simulations using computable general equilibrium (CGE) models, they cover China as a whole, and examine the sectoral impacts at a fairly aggregated level.

58. Plainly put (see for example the review of the literature by Morrison), very few quantitative studies have addressed the regional impact of China's accession to the WTO. The only conclusions available regarding the impact on regional development are derived from aggregated results obtained with a "national" model (Li & Zhai, 1999 and Fan & Zheng, 2000), or simply from a very succinct descriptive analysis (Jiang, 2001). The scarcity of such analysis can probably be explained by the complexity of the models required to run simulations at regional level. This would require the formalisation of a regional CGE model, which would be difficult to construct, *inter alia* because of a lack of available data at a disaggregated level (Qian & Weingast, 1998 and Cheng & Zhang, 1998).[67]

59. The general conclusion that emerges from these studies is that, in the long run, China's accession to the WTO should have a positive effect on both GDP and the population's well-being, mainly because of the efficiency gains that will result from the liberalisation of the Chinese economy (see Morrison, 2001).

6. The cost of these projects is estimated at US$2.8 billion.

7. Very recently, an attempt was made very recently by the Development Research Centre, under the direction of Li Shantong. The model depicts a two-region economy: Guangdong province and the rest of the country. It highlights very distinctly the benefits of WTO accession for Guangdong's economy, which are greater than those for the "rest of China", due to the province's unique economic structure, which is geared towards competitive light industries and is heavily dependent upon foreign trade.

The reallocation of factors of production (labour and capital) to more productive sectors of activity should result in an increase in total factor productivity.

60. Since the launch of the reform process at the start of the 1980s, China has already benefited from the positive effect of sectoral shifts in factors of production on aggregate growth, as various studies have shown (See in particular Borensztein & Ostry, 1996; Sachs & Woo, 1997; Woo, 1998 and Démurger, 2000). In particular, the reallocation of agricultural labour to industrial activities and higher value-added services was an important factor in the growth of aggregate productivity in the 1980s. Given the still large labour surplus in rural China, it may be reasonably inferred that the industrialisation and development of the services expected to arise from trade liberalisation will continue this process of factor reallocation and, in consequence, promote efficiency gains.

61. However, this upbeat long-term outlook is offset in the short term by differentiated sectoral effects liable to lead to a sectoral polarisation in terms of both production and jobs. It is important to consider these short-term effects because they may shape the course of regional disparities in China in the next few years. In particular, the widening of disparities between rural and urban areas, and between coastal and inland areas, may lead to a flare-up of the discontent that already exists, and to a social instability that is not conducive to growth. The Chinese authorities are moreover aware of this risk, as attested by the recent emphasis placed on the development of the western region, and efforts to reform the tax system in rural areas in order to ease the tax burden on farmers (see above). Furthermore, the impact of the sectoral restructuring that is planned (with shifts from agriculture to industry, but also between industrial sectors) will hit many individuals who will lose their jobs and have to find jobs elsewhere. This question is all the more important in that, given the size of China, the number of people affected could attain tens of millions (Li & Lejour, 2000).

62. Behind the apparent consensus on the overall effects of liberalisation, there are many disagreements between the analyses put forward, and various shortcomings that are worth mentioning. The literature on the sectoral impact is characterised by wide disparities in the findings,[8] mainly due to the heterogeneity of the models and data used, the time period under consideration, and the assumptions made regarding the concessions made by China with regard to liberalisation. It is also partial in that most of the sectoral analysis takes into account only certain elements of liberalisation (reduction in customs duties and the phasing-out of the Multifibre Agreement by 2005 in particular), and disregards a whole raft of commitments on non-tariff barriers and on investment restrictions, which will probably have just as large an impact on the Chinese economy and which, by and large, have not been estimated.

63. Despite their shortcomings and their heterogeneity, the predictions of this sectoral analysis provide information that can be useful from a regional perspective, even if, given the diversity of analytical approaches and outcomes of the various studies, it is difficult to summarise the sectoral impact of trade liberalisation in China. Table III.D.2(4) seeks to give a scale of the scope of the expected impact via selected examples of simulations over different time frames by product category. On the whole, it emerges that it is labour-intensive sectors that should benefit from liberalisation. This finding, which is consistent with the theory of comparative advantage, leads to projections of increased production, employment and exports in light industries and non-grain farm output. Conversely, industries that are land -- and capital -- intensive should see their production decline and replaced by imports. In particular, this may be the case with regard to grain and automobiles.

64. More specifically, in respect of agriculture, relatively labour-intensive activities (*e.g.*, production of fruit, vegetables and aquacultural produce) may benefit from liberalisation. In contrast, Chinese grain production would be hit by foreign competition, especially from large world producers like the United

8. These large disparities in the findings are also mentioned by Morrison (2001) and Park (2000).

States and Australia. The grain sector traditionally occupies an important, although declining, place in Chinese agriculture, since “grain” (cereals, tubers and soybeans) represented more than 70 per cent of the cultivated area in 1999 and nearly a third of agricultural output in 1995 (Aubert, 1999). According to initial estimates, grain production fell by 9 per cent in 2000, not only on account of the drought but also because of government measures.[9] In this context, trade liberalisation is likely to be seen as a further cause of deterioration in farmers’ living conditions, which, coupled with the fact that rural incomes have been virtually flat since 1997, could widen the gap between rural and urban areas. The figures for 2000 confirm the trend observed in recent years, with rural incomes up by only 2 per cent compared with 7 per cent for urban incomes.

65. As regards industry, it is light industry that should reap the main benefits from liberalisation; in particular, the textile and clothing industries would appear to be the main beneficiaries, irrespective of the simulations considered.[10] The unskilled, labour-intensive clothing sector already accounts for a large share of China’s exports (15% in 1999) thanks to remarkable growth in the 1990s.[11] The leading world exporter of clothing since 1994, China accounted for 16.7 per cent of world clothing exports in 1998. The most optimistic of the simulations done on China project a further substantial increase in its share of world textile exports due to the phasing-out of the Multifibre Agreement by 2005, but according to some estimates the short-term gain may be smaller because numerous safeguard clauses will still be imposed after 2005.

Table III.D.2(4). **Sectoral effects of China’s accession to the WTO: examples of simulations**

66. In contrast, for capital and/or technology intensive sectors, the impact is projected to be negative due to the higher cost of capital. This would be the case for heavy industry in particular but also for sectors that at present are very protected, like the automobile sector[12]. Lastly, services, which figure only slightly in the simulations, should benefit to a small extent from trade liberalisation by around 2010.

67. Beyond the outcome of CGE models, however, more descriptive analyses would suggest that there will be short-term adjustment costs, potentially substantial in financial sectors (banking and insurance). While the expected long-term effects are clearly positive thanks to the efficiency gains resulting from heightened foreign competition, it is this same competition that may in the short term trigger a crisis in the Chinese financial sector, which at present is very heavily protected. Moreover, losses are expected to be recorded in public services (education, transport and health care) due to the expected drop in government revenue linked to tariff barriers.

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9. The central government lowered the price of low-grade grains in order to encourage production of better-quality crops, which resulted in a fall in the production of some grain. Over-supply and low agricultural prices thus tend to make farmers give up farming. Grain prices are certainly not the only problem facing Chinese agriculture. The scarcity of water and reduction in cultivable acreage are liable to depress grain production sharply in the future.

10. The annex gives a glimpse of the geographic distribution of the main industrial sectors, and of the expected repercussions of WTO membership.

11. China’s clothing exports have more than doubled since 1992, totalling US$30 billion in 1999.

12. Moreover, this sector is all the more likely to be hit by competition in that, on the whole, it is inefficient, since the firms that compose it are small. This prevents it from benefiting from the economies of scale that usually characterise the sector.

68. Sectoral analysis of the gains and losses from trade liberalisation naturally entails differentiating between the impacts on rural areas and urban areas. As China is still a very rural country, with on average 75 per cent of the employed population located in rural areas in 1999, it is important to distinguish between these effects. When one examines the breakdown by province, one sees that even in the North-East provinces, the traditional industrial basins of Maoist China, rural employment represents over half of total employment [Table III.D.2.(6)]. This markedly rural distribution of the employed population means that, regardless of the regions considered, it is of crucial importance to gauge the impact of liberalisation on rural areas. As regards rural populations, the main question posed by the sectoral studies is whether the projected negative effect on grain production and farm incomes could be offset by the positive effect on the textile industry, which is widely developed in rural areas in the form of TVEs. This would require that rural industrial activities absorb the surplus labour in the agricultural sector, but it would be all the more difficult on account of the sectoral asymmetry between production and employment in China: the primary sector now accounts for only a small proportion of production (averaging 16.7% of GDP in 1999) but still accounts for over half the employed population, and even two-thirds in some provinces, and the South-East in particular. For some, the overall impact on China is likely to be negative (Li & Zhai, 1999). Conversely, Carter (2000) suggests a possible narrowing of the wage gap between rural and urban workers, due in particular to higher farm incomes in the wake of accession to WTO. In addition, this overall finding masks potentially large disparities between “rural” provinces, depending on the spatial distribution of non-agricultural rural activities on the one hand, and non-agricultural job opportunities on the other. Thus, it is in non-agricultural employment that provincial disparities appear to be the most marked [Table III.D.2.(6)]. While provinces like Guangdong or Fujian are ostensibly more rural (above average), nearly half of rural jobs are provided by TVEs, *i.e.*, substantially more than the national average of 25 per cent in 1999. Conversely, it is in the remotest provinces like the South-West that rural industry is the least developed. This being so, if potentially surplus labour is located in rural areas a long way from labour markets (those of the textile industry for example), the matter of labour mobility and migration is likely to become particularly acute.

The typological approach

69. The provinces can be divided into six major regional groups, which take account not only of the official tripartite classification (coastal, eastern and western) but also of the economic characteristics shared by certain provinces. The six groups are as follows:

- *Municipalities* (Beijing, Tianjin and Shanghai);
- *Coast* (Hebei, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong and Hainan);
- *North-East* (Liaoning, Jilin and Heilongjiang);
- *Centre* (Shanxi, Anhui, Jiangxi, Henan, Hubei and Hunan);
- *North-West* (Inner Mongolia, Shaanxi, Gansu, Qinghai, Ningxia, Xinjiang and Tibet);
- *South-West* (Sichuan, Chongqing, Guizhou, Yunnan and Guangxi).

70. The last two groups (North-West and South-West) comprise the twelve provinces considered to be western provinces in the Western Development Strategy [Box III.D.2.(4)].

Table III.D.2(5). **Degree of integration of Chinese regional economies into the world economy[1]**

71. As Table III.D.2(5). suggests, the degree of integration of the Chinese provinces into the world economy, as measured by foreign trade and FDI flows, varies widely from one province to another. Export ratios are 3 to 4 times higher along the coast than in the central or western provinces. They also indicate the much greater integration of the coastal provinces into international trade, and their dependence on exports, mainly of manufactured goods. If we compare the ratio of exports to total supply,[13] as measured by the sum of GDP and imports, the gap between the degree of openness of the coast and the interior is smaller, mainly due to the municipalities, which are big exporters, but it also reveals, symmetrically, the low import content of supply in the inland provinces. Virtually all China's foreign trade in 1999 thus came from the coastal provinces and municipalities despite a slight regional diversification of inward direct investment (80% of which however is still concentrated in these two zones). While the weight of the coastal regions in China's foreign trade as well as in FDI fell slightly in the 1990s, it is still well in excess of their weight in China's economic structure, and in employment of course.

72. The limited presence of the central and western provinces in foreign markets is ascribable not only to policies that are less market-friendly, but also to the fact that the economies of these regions are less dynamic. The question thus arises as to whether liberalisation represents an opportunity for these provinces in terms of growth and integration into the world economy. To answer this question, it is necessary to look at the economic structure of these regions more closely in order to identify their potential strengths and weaknesses and to evaluate the cost-benefits of China's accession to the WTO for these specific regions.

73. Table III.D.2(6) provides a statistical overview of the economic structure by main zone and highlights the very different characteristics of each zone. Bearing in mind the sectoral results of the simulations of the expected impact of WTO accession on the one hand, and the structure of the different regional economies on another, it is natural to find that there are "winners" and "losers" in the regional breakdown, which reflect sectoral gains and losses. On the one hand, the municipalities and coastal provinces, the weight of which in the primary sector and extractive industries is relatively small, but large in the TVEs and light industry, especially the textile industry, should be able to benefit from trade liberalisation, by exploiting their comparative advantage in light industry, which can absorb surplus labour from the countryside.[14] On the other hand, the ability of the provinces in the North-East, Centre and West to benefit from trade liberalisation is likely to be more limited on account of certain structural and natural handicaps.

74. The North-West, which contains 10 per cent of China's population on 57 per cent of its territory, is characterised by the predominance of heavy and state industry, especially mining on account of the region's abundant mineral resources. Conversely, the rugged terrain and arid natural conditions are not conducive to the development of large-scale agricultural production apart from cotton-growing, with the region providing over a third of national production of that crop. These characteristics give the North-West a comparative advantage in natural resources, but excessive specialisation in this area can have (and has had) adverse effects of the Dutch disease type. The region's industrial base is still weak, with very

13. By calculating this ratio, it is possible to correct partially the degree of openness as measured solely by exports/GDP, since by taking account of the import content of exports, it makes exports (which represent turnover and not value added) and GDP more comparable.

14. One could however draw attention to the risks associated with early restructuring of the financial sector, for the municipalities in particular.

little light industry, well below the national average. Given the unfavourable natural conditions and the fact that the region is cut off from the rest of the country, it is unlikely that the development of light industry -- where the prospects for growth lie -- will be easy or spontaneous. Transport and market access are also big problems for these provinces.

75. The geographical situation of the south-western provinces is not conducive to economic development. Cut off from the rest of the country, handicapped by undulating or mountainous terrain, they have experienced little industrial development either during the period of central planning or since the introduction of reforms. Enjoying a tropical climate that lends itself to agriculture and allows several harvests a year, they have remained essentially agricultural. In 1999, nearly 85 per cent of jobs were still agricultural. As Table III.D.2(6) shows, industrial rural employment (in TVEs) is very underdeveloped.

76. The question of the geographical isolation of the North-West and South-West regions is very important from the standpoint of the implementation of the Western Region Development Programme [Box III.D.2(4)] and the economic liberalisation that WTO accession will bring. Given the difficult natural conditions, with the problems they pose to entrepreneurs in terms of transport costs and returns on investment, preferential policies by themselves will not suffice to generate flows of investment to these provinces and hasten their industrial development. Their geographical isolation also means that the projected negative impact of WTO accession on rural incomes is liable to be all the greater in the western regions, since they are not only highly dependent on agriculture, but there is no simple alternative available, one of the prerequisites for the reallocation of farm labour to industry being the existence of an environment conducive to industrial development.

77. The economic situation of the North-East provinces is very different from those in the West, since as the former industrial base of Maoist China, the share of the rural population is well below the national average. With agriculture representing only a relatively small part of the economy, these provinces should be less affected by the negative effects of liberalisation on the agricultural sector. In contrast, their industrial structure is geared essentially to heavy industry, which accounted for nearly 80 per cent of their industrial output in 1999, and especially to mining, which alone accounted for almost a third of industrial value added in 1995. To this should be added a large number of State enterprises, which still employ more than half the urban labour force, in those same industries. The problems that the north-eastern provinces are going to encounter are thus very different from those of the western provinces, since they will have to cope with industrial restructuring in urban areas, the pace of which is likely to be speeded up by accession to the WTO. The challenge facing these provinces, whose income level is relatively high owing to the preferential policy during the pre-reform period, is to develop new industries on an industrial base that already exists but which is inefficient and, by and large, obsolete, and to absorb *urban* labour that is very much in over-supply.

78. Lastly, densely populated and rather rural, the central provinces conform to the national average, as shown by the statistics in Table 6. Thus, while they should experience the negative impact of trade liberalisation on the agricultural sector, they should also be able to develop existing light industry, chiefly by increasing their share of national textile production.

79. In conclusion, it emerges from the analysis that three regional groups may potentially suffer from liberalisation (the North-West, the South-West and the North-East), and two groups stand to benefit from it (the municipalities and the coast). In terms of the trend of disparities, this would mean a potential widening of the divide if no back-up policies were introduced to attenuate the negative effects of liberalisation. The proposed typology highlights the importance of differentiating economic policy goals and instruments according to regions. In the case of the western provinces, the main objectives should be to end their isolation and to develop an industrial structure, which at present does not exist. As for the north-eastern provinces, the priority should be the restructuring of the industrial sector.

Tableau III.D.2(6). **Typology of Chinese provinces**

Conclusions and recommendations

80. In addition to special measures to be taken for some of the large regions analysed above, a number of major reforms should also be undertaken to ensure that regional disparities can ultimately be reduced, and that China's economy can reap the full benefits of trade and investment liberalisation. To these ends, four reforms would seem vital: to develop a single Chinese market; create new cities and foster harmonious urban development; reform public finances; and overhaul the system of education and training.

Creation of a genuine single domestic market

81. Given its geographic expanse and the size of its population, but also that of its 31 constituent provinces, China cannot be compared to any other country. It would seem more appropriate to make comparisons with either the European Union (EU) or the North American Free Trade Agreement (NAFTA). The primary objective of both of these undertakings is integration -- integration that is of course limited to trade and investment in the case of NAFTA, but which for the EU extends well beyond these aspects to a host of other areas.

82. The EU's case involves 15 countries -- soon to be around 30 -- seeking, through a comprehensive process of convergence, to create a genuine single European market. Agricultural policy and regional policy are already under the responsibility of Brussels, which expends nearly 1 per cent of Europe's GNP on these areas each year. Trade and competition policies are also centralised, whereas monetary and currency policies are the sole responsibility of the European Central Bank. For the future, other areas of policy convergence are currently under study, involving taxation, the environment, education, social affairs and so on.

83. For the time being, China does not seem to be following the same course. Regional disparities would not appear to be a major concern, since aid for the poorest regions is quite meagre in comparison with the EU's structural funds, and a similar remark could be made in respect of agriculture, which by European standards seems to receive little aid. In addition, however, everything has been undertaken in Europe to facilitate the free movement of goods, services, capital and persons, and the establishment of businesses that enjoy relatively similar -- and ultimately even more similar -- operating conditions regardless of where they are located, while convergence is also taking place in the realms of competition law, taxation and social cover.

84. At the opposite end of the spectrum, with the extensive decentralisation that it has been undertaking for years, China seems to be moving the other way, *i.e.*, towards a fragmentation of its market, giving the various provinces increasing autonomy over economic, tax and social affairs. Internal mobility is still limited for goods, capital, persons and businesses alike; taxation differs widely from one province to another, due in particular to off-budget revenue; in some provinces, public services, such as education, may be privatised; there are several different bodies of competition law; the rules and conditions for establishing a business differ by province, as do customs regimes; lastly, Beijing has scant budgetary capacity to harness a nation-wide infrastructure development policy for genuine land-use planning. For all these reasons, China would appear to be headed not towards a single domestic market, but towards a juxtaposition of provinces without any great level of coherence or cohesion.

85. This policy, which would seem antithetical to the integration policies of Europe or North America, poses major problems: the difficulty for businesses to attain nation-wide size and thus to become more competitive thanks to economies of scale; a lack of flexibility of domestic markets, including the labour market, with mobility of production factors being an essential condition of market efficiency; the difficulty of introducing structural reforms, and especially regulatory reforms, given the large (and rising) volume of provincial regulations; widening disparities between coastal regions and the interior, and between rural areas and urban ones, which could ultimately trigger a certain social instability and adversely affect the rise in China's overall level of prosperity. Major reforms are therefore crucial for the construction of the single domestic market that China lacks.

Fostering the creation and development of cities

86. In effect, China is undergoing two transitions: an economic transition to a modern market economy, and a transition from a rural to an urban society. TIL is going to accelerate both transitions and to make them both interdependent.

87. City-building concurrent with, and in advance of, the shedding of surplus agricultural labour and the reform of state-owned enterprises (SOEs) would be desirable in rural regions to channel the migration of people and to constitute an alternative source of growth as cities over 100 000 generally generate their own growth. However, the goal of preparing cities for newcomers, providing them with decent housing and avoiding the problems of shantytowns, is difficult to realise, and restrictions on migration to cities would need to be limited.

88. City-building is not problem-free. It is characterised by a mix of many small firms and a few large ones, and often of traditional and very modern working methods and technologies. The production of materials can form local chains of supply. Typically construction for housing (which represents about 80 per cent of the construction sector by value) amounts to about 4 per cent of GDP. Shortages of skilled workers and managers, of designers, and of supervisors and inspectors are likely to be greater than shortages of supplies. Without credit mechanisms, housing is likely to be either self-financed or financed by investors who become landlords; in either case, housing prices and rents are not likely to be very transparent, restricting information to consumers.

89. Another consideration in city-building regards planning. Rapid construction often means that environmental considerations are disregarded, that infrastructure provision is poorly co-ordinated with housing construction, and that simplistic and monofunctional zoning dominates. China has the opportunity to innovate with more flexible spatial planning systems for "smart growth" that can promote the further development of cities at lower risk and cost, reducing pollution, waste generation and energy consumption which will rise with growth and incomes. This is particularly the case in a country where a large number of the world's worst natural disasters occur regularly, with high loss of life and, as urbanisation advances, increasingly extensive damage to property.

90. Cities that are poorly built when new need to be re-built later. This process can help facilitate sectoral change and the introduction of new technologies. But it can also destroy existing and vibrant communities and sectors, reducing the adaptability of the urban social system to cope with change and shocks. Indeed, there is the risk that the existing economic base will be weakened faster than a new one can take its place. In any case, urban development must be combined with measures that foster entrepreneurship, promote the creation of new small firms, improve access to education and abolish restrictions on people who want to leave rural areas and settle down in cities (*Hukou*). Cities in the hinterland will also need better transport and communication access, and the advice of people experienced

with local economic development strategies. The greatest risk is that the number of very poor people in cities will increase.

91. Separately, the dynamic coastal regions will need to cope with the addition of more cities of over 1 million, with the further growth of several very large cities, and with the changes in the sectoral mix and spatial organisation of these metropolitan economies.

Reforming public finances

92. Comparisons with international experiences suggest that the Chinese budgetary regime is extraordinarily decentralised. The process of decentralisation tends to exacerbate regional disparities. Moreover, the extent of decentralisation is in fact much greater than the trends indicated in the budgetary data because of the increasing reliance on off-budget funds.

Devise a new budgeting constitution

93. A clear and detailed division of responsibilities for spending and revenue allocation should be defined. Central government currently accounts for only about 10 per cent of total expenditures on "culture, education and health" -- the category that encompasses 80-90 per cent of social expenditures in the Chinese budget (Wong, 1995). Such functions should be returned from the local level (townships, districts and municipalities) to higher tiers of government (provinces or the central State).

94. The present structure of off-budget fees and levies must be reformed, abolishing arbitrary ones and incorporating legitimate ones into the formal system of budgetary accounting. Including EBF in the official budget would not only be a notional improvement, but it would also enhance the predictability and transparency of local public finance.

95. On the whole, the extremely complicated structure of provincial taxation (27 taxes at the sole discretion of Chinese regions!) should be simplified. The increasing budget deficits facing local governments should be reduced by increasing their own resources. Revenues from some taxes levied at the provincial level should accrue to local governments. For instance, the five current land and building taxes should be merged, transformed into a value-based property tax and devolved to local governments.

Streamline the system of intergovernmental grants

96. A formal programme of earmarked/conditional transfers must be established, targeted to achieve a number of well-defined policy goals such as poverty alleviation and achieving minimum standards in basic services (education, health, and social security). These grants aimed at promoting local public services should be paid on the basis of the cost and quality of the services rendered. The central government should set up monitoring mechanisms for this type of vertical grants. The possibility of transforming the *Suishou Fou Huan* into a horizontal equalisation grant should also be considered.

Strengthen the equalisation system and increase the central budget

97. The current scheme must be replaced by a system of horizontal equalisation whereby rich local governments provide more support for poor ones (as do the German *Länder*). The new equalisation system should only take into account disparities in tax-raising capacities. Grants for fiscal equalisation should be entirely unconditional. The equalisation system should provide all local governments with adequate

financial resources without, however, loosening local budget constraints. The effectiveness of the system also requires increasing the size of the central budget.

Reforming the system of education and training

98. Balanced economic development in China requires an active education policy capable of giving the population the training that is needed to fill the country's increasing requirements for skilled labour. This will entail continued emphasis on making basic education universal, and on developing vocational and technical training throughout China. Given the widening disparities between provinces and between rural areas and urban ones, and in the delivery and quality of education services, it is necessary to reconsider how the education system is funded, in respect of disadvantaged areas in particular.

99. The decentralisation process that accompanied the reforms undertaken by China over the past 20 years has profoundly altered the way in which the Chinese education system is financed. Since responsibility for primary and secondary education has now been devolved to local (sub-district) governments, funding is far more heavily dependent on these governments' capacity to raise the necessary funds from local populations, leading to de facto inequality depending on the basis of wealth levels.

100. Clearly a redistribution system exists to benefit poor regions, but this system remains highly marginal in relation to needs. The system is based on priority allocation to disadvantaged areas of categorical grants by higher levels of government (the provinces or the State), in respect of specific educational objectives (*e.g.*, repairing school buildings, teacher training, technical education, etc.).

Increasing the financial resources allotted to education and encouraging intergovernmental transfers

101. Despite substantial efforts to diversify revenue sources in recent years, the Chinese education system suffers from a funding shortfall. With education spending representing a mere 2.5 per cent of GNP, China trails behind other countries with a comparable level of development. Given the substantial resource constraints in rural areas and the at times high tuition fees, the State's commitment to basic education remains more necessary than ever to ensure that the education system achieves a minimum level of performance throughout the entire country. *Inter alia*, this will require Beijing to earmark substantially increased resources for basic education, and that disadvantaged areas be given priority in the allocation of these resources (see above). Moreover, the redistribution of central and provincial government financing to lower echelons of local government, and to villages in particular, should be made systematic in order to ease the budget squeeze on the poorest regions.

Putting the emphasis on universal basic education

102. While the 1986 law imposing nine years of compulsory education (primary and the first half of secondary school) boosted schooling rates and lowered illiteracy in the youngest age cohorts, sharp disparities persist, depending on place of residence and sex. For example, people living in western provinces, as well as women, are over-represented in the illiterate population, which, while less than 15 per cent for the country as a whole, rises to nearly 40 per cent for the women of Qinghai province. In this context, it is important to set priority goals that are differentiated by region, and to put the emphasis, through awareness-building campaigns and welfare payments to the most highly disadvantaged families, on the education of girls, too many of whom in rural areas still drop out after primary school, *inter alia* because of the high cost of education.

Improving schooling conditions in country areas

103. Lastly, special attention needs to be paid to improving schooling conditions in disadvantaged areas. Teacher training in rural areas is often still rudimentary, and the variety of languages and dialects spoken in certain remote areas (due to the presence of numerous minorities) confronts education with an additional difficulty.

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ANNEX. GEOGRAPHICAL BREAKDOWN OF CHINA'S INDUSTRIAL SECTORS AND EXPECTED IMPACT OF WTO MEMBERSHIP

Industrial sector	Expected impact	Main provinces concerned	
		Value added[2]	Employment[2]
Clothing	Strongly positive	Fujian (7.4%) Guangdong (6.2%)	Guangdong (11.4%) Fujian (7.4%)
Textiles	Positive	Xinjiang (20.7%) Jiangsu (15.5%) Zhejiang (15.4%)	Xinjiang (23.2%) Zhejiang (23.2%) Jiangsu (20.4%)
Electronics	Ambiguous	Tianjin (21.6%) Shaanxi (18.9%) Guangdong (14.3%) Beijing (11%)	Guangdong (7.6%) Shaanxi (5.1%) Beijing (5%) Tianjin (4.1%)
Mining	Slightly negative	Heilongjiang (59.1%) Xinjiang (55.5%) Shanxi (37.8%) Qinghai (29.2%) Inner Mongolia (23.7%) Tibet (22.7%)	Shanxi (35.6%) Heilongjiang (33.3%) Inner Mongolia (29.6%) Xinjiang (27.9%) Ningxia (25.1%) Tibet (22.2%) Qinghai (21.1%)
Heavy industry[1]	Slightly negative	Inner Mongolia (44.4%) Shanxi (37.6%) Qinghai (29.9%) Liaoning (29.7%) Beijing (29.1%) Hebei (28.0%) Sichuan (23.9%) Gansu (23.9%) Ningxia (23.3%) Hubei (23.1%) Jilin (22.1%) Shanghai (21.0%)	Shanxi (26.4%) Qinghai 23.6%) Hebei (19.2%) Yunnan (18.9%) Inner Mongolia (18.7%) Ningxia (18.3%) Liaoning (18.3%) Guizhou (15.6%) Gansu (15.1%)
Timber and paper	Slightly negative	Qinghai (32%) Gansu (26.3%) Ningxia (18.4%) Guizhou (12.9%)	Gansu (15.4%)
Machinery / equipment	Negative	Guangdong (8.9%) Zhejiang (7.5%) Jiangsu (7.2%) Shaanxi (7.1%)	Sichuan (10.1%) Guangdong (8.2%) Shanghai (7.2%)
Beverages / tobacco	Negative	Yunnan (64.4%) Guizhou (29%) Hunan (17.1%) Anhui (14.3%) Hainan (14.1%) Sichuan (12.1%)	Guizhou (8.6%) Yunnan (6.5%)
Automobiles	Strongly negative	Jilin (32%) Hainan (18.7%)	

1. "Heavy industry" includes petrochemicals and metals (Ianchovichina, Martin & Fukase, 2000).
2. The percentages in parentheses give the sector in question's share of the province's manufacturing output (except for mining, where they indicate the percentage of aggregate industrial production).

Source: 1995 Industrial census.

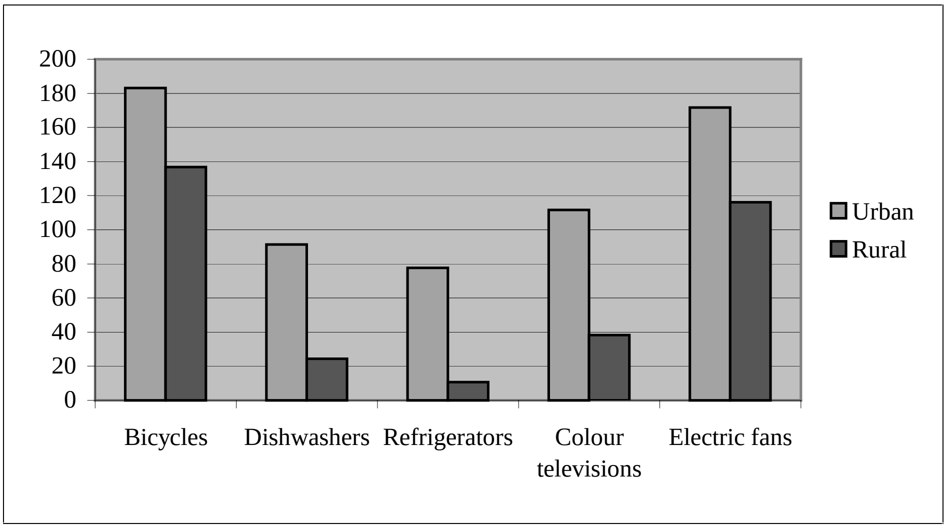
Table III.D.2(1). **The urban/rural development gap**

Indicator (per capita)	Real income (1995)	Savings deposits (1995)	Consumption (1995)
Ratio town : country	2.79	11.4	3.41

Source: Xu (1997) and Li (1999, Table 3).

Figure III.D.2(1). **The urban/rural gap in living standards: consumer goods**[1]

1999



3. Number of appliances owned per 100 households at year-end.

Source: *China Statistical Yearbook* (2000).

Table III.D.2(2). **Disparities between provinces: economic indicators**

1999

Provinces[1]	GDP (CNY million)	Per capita GDP (CNY)	Average yearly wage (CNY)	FDI (US$ million)	Rural enterprises[2]
Shanghai	403 496	30 805	16 641	2 837	150
Beijing	217 446	19 846	14 054	1 975	96
Tianjin	145 006	15 976	11 056	1 764	114
Zhejiang	536 489	12 037	11 201	1 233	814
Guangdong	846 431	11 728	12 245	11 658	1 178
Fujian	355 024	10 797	9 490	4 024	530
Jiangsu	769 782	10 665	9 171	6 078	821
Liaoning	417 169	10 086	7 895	1 062	439
Shandong	766 210	8 673	7 656	2 259	1 281
Heilongjiang	289 741	7 660	7 094	318	149
Hebei	456 919	6 932	7 022	1 042	788
Hubei	385 799	6 514	6 991	915	657
Xinjiang	116 855	6 470	7 611	24	75
Hainan	47 123	6 383	6 865	484	27
Jilin	166 956	6 341	7 158	301	249
In. Mongolia	126 820	5 350	6 347	65	385
Hunan	332 675	5 105	7 269	654	922
Henan	457 610	4 894	6 194	521	858
Chongqing	147 971	4 826	7 182	239	144
Shanxi	150 678	4 727	6 065	391	317
Anhui	290 859	4 707	6 516	261	496
Qinghai	23 839	4 662	9 081	5	23
Jiangxi	196 298	4 661	6 749	321	307
Ningxia	24 149	4 473	7 392	51	49
Yunnan	185 574	4 452	8 276	154	235
Sichuan	371 161	4 452	7 249	341	586
Tibet	10 561	4 262	12 962		2
Guangxi	195 326	4 148	6 776	635	344
Shaanxi	148 761	4 101	6 931	242	391
Gansu	93 198	3 668	7 427	41	149
Guizhou	91 186	2 475	6 595	41	128

1. Provinces are ranked in descending order of 1999 per capita GDP.
2. Number of workers per 10 000 in the labour force.

Source: *China Statistical Yearbook* (2000).

Table III.D.2(3). **Disparities between provinces: social indicators and digital divide**

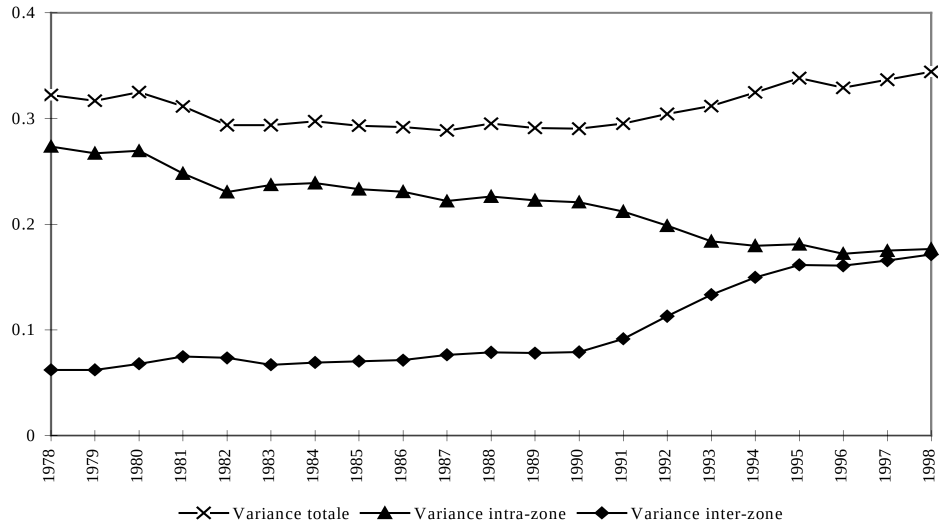
Provinces[1]	HDI rank 1995	Health care services[2] 1999	Illiteracy (%) 1999	Computers per 100 population 1997
Shanghai	1	364	8.68	8.60
Beijing	2	477	6.45	12.20
Tianjin	3	310	8.03	5.00
Zhejiang	5	373	15.70	3.08
Guangdong	4	174	9.23	9.05
Fujian	8	306	18.46	2.24
Jiangsu	6	190	16.79	2.22
Liaoning	7	288	7.18	1.45
Shandong	9	164	20.15	1.77
Heilongjiang	10	200	9.77	0.86
Hebei	12	303	11.42	1.57
Hubei	17	190	14.98	1.36
Xinjiang	15	372	9.77	0.99
Hainan	11	323	14.58	1.60
Jilin	13	251	6.81	0.84
In. Mongolia	22	319	16.44	1.13
Hunan	20	273	11.13	2.68
Henan	16	124	16.31	1.09
Chongqing		313	14.75	4.00
Shanxi	14	268	9.14	1.35
Anhui	19	109	20.28	1.05
Qinghai	28	472	30.52	1.78
Jiangxi	23	190	13.15	1.78
Ningxia	24	265	23.32	1.06
Yunnan	26	283	24.34	1.58
Sichuan	21	382	16.77	1.80
Tibet	30	490	66.18	N/A.
Guangxi	18	283	12.35	1.58
Shaanxi	25	292	18.29	0.91
Gansu	27	353	25.64	2.20
Guizhou	29	262	24.46	1.20

1. Provinces are ranked in descending order of 1999 per capita GDP.
2. Number of hospitals, clinics, maternity facilities and dispensaries per million population.

Source: UNDP (1995) and *China Statistical Yearbook* (2000).

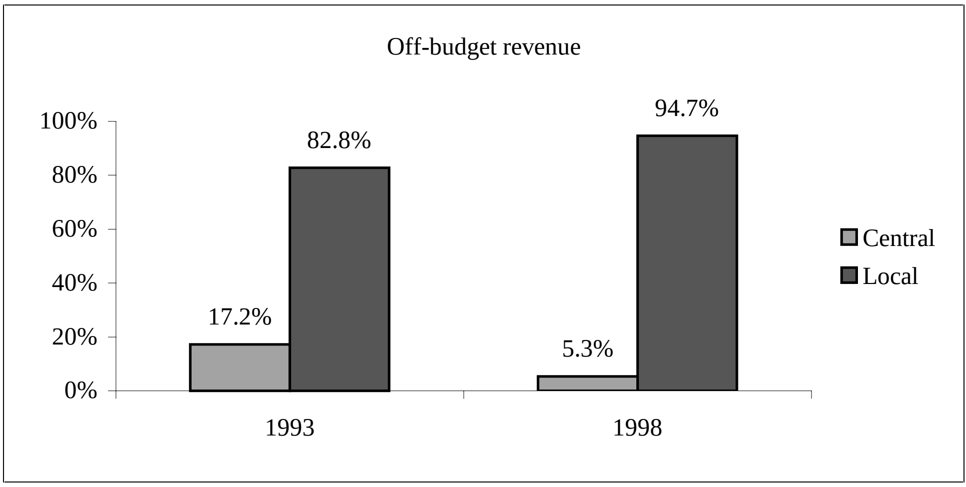
Figure III.D.2(2). **Dispersion trends measured by the log variance of per capita GDP**

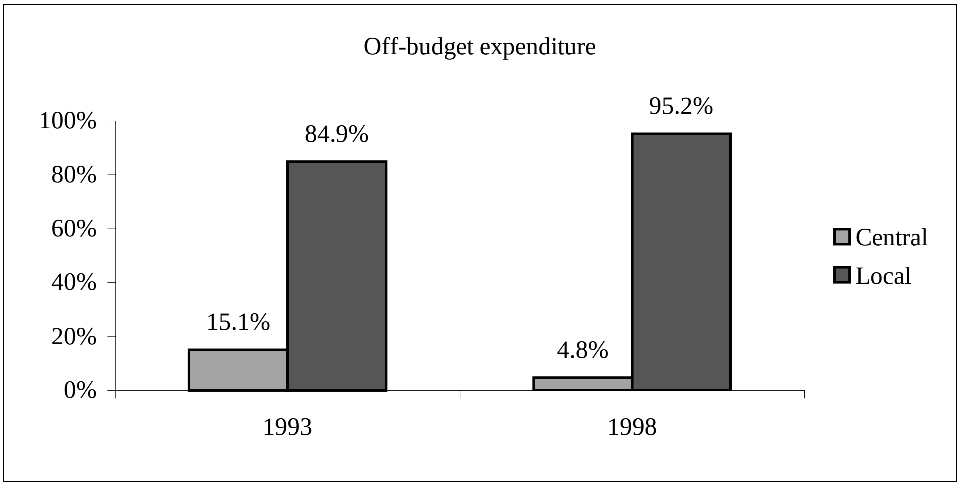
1978-98



Source: Démurger (2000), Data updated by the author.

Figure III.D.2(3). **Proportion of off-budget revenue and spending: central vs. local government**





Source: *China Statistical Yearbook* (2000).

Table III.D.2(4). **Sectoral effects of China's accession to the WTO: examples of simulations**

Sector	Magnitude of the expected effect[1]		
	2005 Production	2010 Production	2010 Employment
Agriculture			
Food grain	-0.1	N/A.	N/A.
Forage seeds	-2.0	N/A.	N/A.
Wheat		-15.7	-16.1
Meat and dairy products	6.3 to 9.5	1.7 to 3.3	0.5 to 2.5
Industry			
Textiles	16.4	11.5	6.1
Clothing	206.5	43.7	38.7
Automobiles	-193.4	-21.4	-23.5
Electronics	26.6	4.7	3.4
Machinery/equipment		1.2	0.1
Construction	1.1	0.6	0.5
Petrochemicals	-7.2		
Metals	-9.5		
Mining	-1.7	N/A.	N/A.
Beverages/tobacco	-66.9		
Timber and paper	-9.7		
Services		1.5	1.1
Public services	0.9		

1. Percentage change as compared with a reference situation without WTO membership.

Source: Projections for 2005 are taken from Ianchovichina, Martin & Fukase (2000), and for 2010 from Wang (1999).

Table III.D.2(5). **Degree of integration of Chinese regional economies into the world economy[1]**

Share of each group in :	Exports			Imports		Openness[2]		Inward direct investment
	Total	Manu-facturing	Enterprises with foreign capital	Total	Enterprises with foreign capital	In % of GDP	In % of the total offer	
Municipalities	18.0	13.3	18.4	30.5	24.9	37.9	24.5	16.5
Coast	69.1	70.7	73.8	58.5	65.9	29.5	24.3	67.1
North-East	5.2	5.2	5.6	4.8	5.5	9.6	9.0	4.2
Centre	3.8	5.9	1.3	2.6	2.4	3.4	3.3	7.7
South-West	2.2	3.1	0.6	2.0	1.0	3.6	3.5	3.5
North-West	1.8	1.7	0.4	1.6	0.4	5.2	5.0	1.1
Total	*100*	*100*	*100*	*100*	*100*			*100*

1. 1999 figures except for manufacturing exports (1997 data).
2. The degree of openness measures the ratio of exports to GDP, and to the sum of GDP and imports, respectively.

Source: *China Statistical Yearbook* (2000), *Almanac of China's Foreign Economic Relations and Trade* (1998).

Tableau III.D.2(6). **Typology of Chinese provinces**

Zone	Munici-palities	*Coast*	North-East	Centre	South-West	North-West	National
Population distribution in % (1999)	3.0	31.0	8.6	28.6	19.5	9.3	
Area in %	0.4	9.2	8.2	10.7	14.2	57.3	
GDP composition (1999)							
Primary sector	3.1	14.5	15.1	21.6	24.8	21.9	167
Secondary sector	45.8	49.3	48.8	44.4	40.7	41.6	46.5
Of which industry	39.8	43.0	42.9	38.5	33.6	31.6	40.0
Tertiary sector	51.1	36.1	36.1	34.0	34.5	36.4	36.8
Structure of employment (1999)							
Share of rural employment in total employment	34.4	75.6	53.7	78.6	84.5	69.5	75.0
Share of TVEs in rural employment	60.7	35.9	34.0	25.2	13.2	29.2	27.1
Share of SOEs in urban employment	55.5	49.0	55.3	55.6	60.8	63.4	55.0
Share of primary sector in total employment	14.6	46.3	44.4	58.0	65.7	57.7	53.6
Distribution of main crop production (1999)							
Cereals	1.3	30.1	13.8	29.,5	16.4	8.9	
Cotton	0.3	22.2	0.1	38.4	2.1	37.0	
Fibres	0	6.5	31.5	42.0	14.4	5.6	
Industrial structure							
Share of light industry in industrial production (1999)	36.1	50.3	21.7	36.2	42.5	25.0	42.0
Share of mining in the industry of each region (1995)	2.2	8.1	31.9	13.5	9.9	25.6	12.4
Share of chemical industry in the manufacturing industry of each region (1995)	6.3	7.9	9.0	7.1	8.3	8.7	7.7
Share of textile industry in the manufacturing industry of each region (1995)	9.4	17.8	3.6	9.1	3.6	8.9	11.8
Textile industry[1]							
Distribution of the added value of the textile industry (1995)	11.5	64.7	2.8	14.4	3.1	3.5	
Distribution of the added value of the textile industry generated by TVEs (1998)	8.8	76.8	2.9	9.7	1.0	0.9	

4. Note : The “textile” industry comprises the textile, clothing and leather sectors.

Source: *China Statistical Yearbook* (2000), *China TVE Yearbook* (1999) and 1995 industrial census.